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SUBJECT: BABCOCK & BROWN'S SHAREPRICE MELTDOWN

¶1. (U) Summary: Australian investment bank Babcock & Brown (B&B) lost over half its share value in the week of June 9 over concerns it could not manage its debt load. B&B stock has been recovering this week. The Australian Securities Exchange has said there is no sign of market manipulation; regulators have been quiet. B&B is a large operator in North America and Europe as well as in Australia, in particular in infrastructure and energy. End summary.

¶2. (SBU) Babcock & Brown (B&B) is Australia's second-largest merchant (investment) bank with an emphasis on infrastructure funds and significant investments in the United States and Europe in addition to Australia. Its operations in North America are significant - in 2007 35% of B&B's global revenues of A\$2 billion (A\$1 = US\$0.94 approximately) came from North America, and about a third of its A\$56 billion worth of managed assets are in North America, including major ethanol and wind energy projects and the consortium to build and operate the Miami Access Tunnel in Florida. It also has real estate and transport projects in North America.

¶3. (SBU) B&B followed in the footsteps of its larger Australian rival Macquarie Bank in buying infrastructure assets and then spinning them off into separate companies that hired B&B for long-term management contracts. Babcock made money from charging a transaction fee for the original purchase as well as the sale, as well as handling the bond issuances in addition to the management fees. In addition, B&B was then able to list a number of these companies on the Australian Stock Exchange. This model generated significant revenue streams, making B&B very profitable and allowing rapid expansion - Babcock and its related companies hold assets around the world estimated as being worth between \$60-80 billion. However, B&B depended on very significant leverage, first to do the deals themselves and then to operate its companies. This has made it very vulnerable to higher funding costs, particularly as B&B is viewed by the markets as being opaque about its operations and exposure to higher funding costs.

¶4. (U) Like many financial institutions, B&B had felt downward pressure on its share price since October 2007, thanks to global financial conditions. But the pressure on B&B grew extreme during the short Australian trading week last week. Amid concerns that B&B's debts, including a new A\$2.8 billion loan closed in April, were growing too great to manage, B&B share prices fell from A\$11.16 to A\$5.25 last week. The rout picked up later in the week after analysts pointed out that a drop below A\$7.50 would reduce B&B's market capitalization below A\$2.5 billion, which would allow creditors to call for a review of the April A\$2.8 billion loan. To date, no such call for a review has been made.

15. (U) Business reporting and media analysis also indicates a lack of confidence in B&B management. This week, B&B has announced plans to appoint independent chairman to the boards of its four Australian-listed satellite funds that don't already have such positions. So far this week, B&B has recovered some lost ground; as of mid-afternoon Wednesday June 18, its share price was up to A\$6.86.

16. (SBU) The question of market manipulation has been mentioned in at least one media report about the B&B rout and has been suggested by some of our contacts. The Australian Qhas been suggested by some of our contacts. The Australian Securities Exchange has said it is closely monitoring trading in B&B, but noted it saw no indication of any manipulation. The Australian Securities and Investment Commission has made no public comment. One experienced economic journalist told us he was convinced this was a case of manipulation. A longtime contact who is a trader at a major investment bank expressed similar sentiments, though stressing that he had no proof. He speculated that hedge funds had targeted B&B because of its size (big enough to make a raid worthwhile but small enough to minimize the chances of getting burned) and very legitimate questions about its funding model.

17. (SBU) A trader with a bank in Melbourne told Embassy that the questions in financial circles were centered on where all the sold B&B stock came from. He said there was talk that the B&B slump was driven by speculative short-selling by hedge funds, and that the improvement in B&B's share price this week could be short-sellers buying stocks in order to meet their contracts rather than a fundamental judgment in B&B's viability as a good place to invest. He also noted that Fidelity's recent decision to drop its holdings in B&B

CANBERRA 00000623 002 OF 002

from 7.5% to 5% would also have increased downward pressure on B&B's share value. Another financial journalist expressed doubt about reports of manipulation, saying that some of the complaints sound like sour grapes from people who were burned by the rapid fall in the share price. However, this contact commented that he has been surprised by the extent and the persistence of rumors that B&B's share price collapse reflected some kind of manipulation.

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